II. HISTORY OF ISSUE/INTERAGENCY TEAM

A. Events Leading to Team Formation

The question of potential Federal oil royalty underpayment in California goes back many years. The issue is the relationship of oil posted prices[3] to royalty value--whether major California oil companies established posted prices at inappropriately low levels and, by paying royalties based on such prices, underpaid their royalty obligations.

In 1975, the State of California (State) and the City of Long Beach (City) began what would turn into very lengthy litigation against seven major integrated oil companies operating in

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[3]Traditionally, oil posted prices represented prices oil purchasers were willing to pay for particular crude oils in specific areas. Since they often provided the basis for arm's-length purchases and sales, they generally were considered to be representative of market value. Posted prices, as well as other arm's-length contract prices, factored heavily into the revised MMS oil product valuation rules that went into effect March 1, 1988. But in recent years, posted prices have been increasingly criticized in a number of States as not being representative of the true market value of crude oil. For example, in 1995 the Texas General Land Office sued several major oil companies, alleging that they based royalty payments on posted prices known to be below a fair market price. Also, the States of Colorado, New Mexico, and Texas recently commissioned a study by Summit Resource Management, Inc., to analyze crude oil royalty payments in those States. The study concluded that most of the major oil companies have apparently paid their royalties based on postings, but that the posting used by most companies is considerably less than the true value of the oil.

California. They initially alleged that these companies had conspired to keep posted prices low and that the State and City had been damaged because oil revenues from their lands depended on posted prices. The State alleged that evidence collected in the case indicated companies operated a dual pricing system that involved trading oil among themselves at effective values higher than posting for much of the 1960's and early 1970's. An extensive body of company materials covering the 1980's showed that major companies often bought and sold crude oil at premiums over posted prices.

After protracted litigation covering the periods 1971-77 (Long Beach I) and 1980-89 (Long Beach II), six of the companies involved (ARCO, Shell, Chevron, Mobil, Texaco and Unocal) reached monetary settlements of approximately $345 million (of which $320 million was in cash) to end the actions alleging undervaluation on State and City leases.[4] Dollar amounts cannot be tied to specific findings, and issues other than valuation were involved.

In 1986, as the State and City litigation continued, MMS contacted State officials and other sources to obtain information to assess the appropriateness of posted prices as the royalty value basis. After its review, MMS concluded that posted prices fairly represented royalty value. At the time, MMS did not conduct an extensive review of the evidence being gathered in the State's case against the companies. Rather, the fact that the

[4]ARCO negotiated a settlement in 1984, and five companies settled in 1991. The remaining company chose to continue in court and has thus far been successful.

State and City thus far had been unsuccessful in their antitrust claims in court weighed heavily in MMS' decision. At about the same time the Justice Department looked into the issue and chose not to pursue an investigation.

In late 1993, in light of the settlements between the companies and the State/City, MMS performed a scoping exercise to estimate the size of any potential Federal royalty underpayments. Using rough per-barrel undervaluation estimates from the State/City legal counsel and their consultants, MMS decided the potential amounts warranted further analysis of the issue. Using publicly-available information, the MMS performed additional studies for the period 1986 forward. The preliminary conclusions were that, based on the information available, MMS could not definitively state that postings were underpriced or that royalties had been underpaid. But before reaching any final conclusion, the MMS Director consulted with State officials. They agreed that MMS should seek additional input from other agencies, and the State would assist MMS in gaining access to the court-sealed contract records the State had gathered in the course of the Long Beach II litigation. The Department and the interagency team (team) then pursued acquisition of the court-sealed data.

B. Interagency Team Formation and Composition

In their discussions, MMS and the State agreed that the Department of Energy and the Department of Justice could bring valuable experience and insight to the issue. So, as originally composed in June 1994, the team included:

- A member from the Department of Energy who has long experience in the issue;
- A lawyer from the Department of Justice's Antitrust Division;
- Two MMS employees with significant experience in the issue; and
- A lawyer from the Interior Department's Solicitor's Office for advice on various issues.

A Commerce Department employee with significant related experience then volunteered and became the final team member. In addition, various individuals have represented the State in many of the team's working meetings.[5]

C. **Team Mission**

As stated by the team leader in an October 28, 1994, memorandum to team members,

> Our purpose is to obtain any additional data that would enable MMS to determine conclusively whether the posted prices used by the major oil companies in California to

[5] As of the team's most recent presentation in December 1995 in Washington, the Department of Justice representative "resigned" from the team. She indicated that since the issues the team is dealing with don't involve antitrust, there was little purpose for her participation.

value crude oil from Federal leases reflect market value. To accomplish this, we have agreed to do at least the following:

1) Review documents under court seal at the law firm of Hoecker, McMahon, et. al. related to the State of California/City of Long Beach litigation against the majors. As of October 26, 1994, all companies except Union had agreed to let us review these documents[6].

2) Interview auditors with the California Controller's Office regarding their past and ongoing audits as related to oil valuation.

Regarding item (1), we would share any apparent evidence of undervaluation with the Interior Department Solicitor's office for recommendations on further action. For item (2), if discussions with the California auditors and/or review of their data lead us to believe that further audits should be conducted, we would define the needed resources and request them through the Associate Director for Royalty Management. If the Associate Director agrees that additional audits should be conducted, MMS will conduct these audits or have them conducted by State or contract auditors.

The memorandum cited the MMS oil valuation regulations at 30 CFR § 206.102 as a controlling factor in the team's activities.

[6]The review of the documents was significant because they could reveal contractual data regarding the valuation of crude oil for royalty purposes and allow the team to share evidence concerning undervaluation with MMS auditors and the Interior Department's Solicitor.

III. SUMMARY OF TEAM ACTIVITIES

A. Review of MMS Royalty Valuation Regulations

1) General

The problem of valuing California crude oil under MMS' royalty valuation regulations is complicated by two factors. First, most oil from Federal oil and gas leases is produced by integrated companies that transfer production from their production arm to a trading or refining arm. After this initial non-arm's-length transfer, oil produced from Federal leases loses its identity in companies' accounting systems so that its price in subsequent transfers cannot usually be determined. Second, most subsequent transfers by integrated companies are exchanges of one type or another. Some of these are simply to accomplish transportation on California integrated refiners' pipelines, while others are to obtain crude oil in locations that are more favorable to both exchange partners. In some exchanges (which we call straight or pure exchanges), contracts do not specify a price for the crude oil but only provide for a location differential to be paid by one of the parties. In other cases (termed buy/sells) contracts specify both a purchase and a sales price, and often include a location differential as well.

The team devoted considerable time to evaluation of MMS' valuation regulations because a determination of the adequacy of California company royalty payments must be made in the context of applicable MMS regulations. MMS' royalty valuation regulations were revised in 1988, dividing the period the team reviewed into two parts. Prior to March 1, 1988, MMS' royalty valuation regulations were at 30 CFR § 206.103 for onshore leases and at 30 CFR § 206.150 for offshore leases. 30 CFR § 206.103 stated:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production . . . be less than the gross proceeds accruing to the lessee . . . or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, . . . paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, . . . produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

30 CFR § 206.150 contained similar directives. However, it also directed MMS to consider regulated prices. This regulation is quoted in Appendix 1. 30 CFR § 206.103 was promulgated in similar form in 1942 and 30 CFR § 206.150 was promulgated in 1954. The royalty valuation lease terms for both onshore and offshore Federal oil and gas leases are almost identical to these regulations.

Neither these regulations nor the lease terms provide separate directives for valuation under arm's-length and non-arm's-length contracts. Both of these regulations set gross proceeds as minimum value and instruct MMS to consider posted prices as well as actual purchases and sales for oil produced from the same field or area in determining royalty value. Also, 30 CFR § 206.103 specifically relies on prices offered in "a fair and open market" for oil produced from the same field or area. Thus, in establishing royalty value, the regulations and lease terms emphasize the use of arm's-length contracts for oil produced from the same field or area as the oil being valued. Additional flexibility is imparted by including other relevant matters.

When MMS revised its regulations in 1988, it added specific guidance for valuing oil not sold under arm's-length contracts. This is particularly relevant in California, because most oil is produced by integrated oil companies that "sell" it to their trading or refining affiliates. Although the revised regulations maintained the principle that gross proceeds are minimum value for oil sold under both non-arm's-length and arm's-length contracts, they seemed to afford posted prices a more prominent role in valuing non-arm's-length sales. In valuing oil not sold under arm's-length contracts, the revised regulations continue to direct MMS to rely on arm's-length contracts for sales and purchases of oil produced from the same field or area as the oil being valued.

Specifically, on and after March 1, 1988, the present 30 CFR § 206.102(b) provides that crude oil sold under an arm's-length contract will be valued at the gross proceeds accruing to the lessee under the contract. However, if the contract does not reflect the total consideration transferred from buyer to seller, MMS may require that value be established under its benchmarks (discussed below) used to value production not sold at arm's length. Regardless, value cannot be less than total consideration accruing to the lessee. 30 CFR § 206.102(b)(1)(ii). Furthermore, if MMS determines that the gross proceeds accruing to the lessee do not reflect the reasonable value of production due to misconduct or the lessee's failure to market the production for the mutual benefit of the lessor and lessee, MMS shall require that the production be valued under its benchmarks. 30 CFR § 206.102(b)(1)(iii).

If crude oil is not sold under an arm's-length contract, the present 30 CFR § 206.102 (c) provides that value shall be determined according to the first applicable of a series of specific "benchmarks" listed in a prescribed order. The first benchmark is a key to the present analysis. It establishes value as:

> The lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field . . . [or, if necessary, area]; provided, however, that those posted prices or oil sales contract prices are comparable to other contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field . . . [or, if necessary, area]. . . . If the lessee makes arm's-length purchases or sales at different postings or prices, then the volume-weighted average price for the purchases or sales for the production month will be used.

30 CFR § 206.102(c)(1).

This benchmark requires a double "significant quantities" test. For a company to use its own postings or oil sales contract prices for crude oil it bought or sold at arm's-length as the value of crude oil not sold at arm's-length, both the arm's-length postings or oil sales contract prices to be used as the measure of value and the arm's-length postings or oil sales contract prices to which they are comparable must be for "significant quantities." Finally, if there are multiple postings or oil sales contract prices for arm's-length transactions, then the lessee must use the volume-weighted average of those prices.

If the required elements of the first benchmark are not met, then the regulation directs MMS to proceed to subsequent benchmarks. See Appendix 1 for a complete discussion of the regulation. Ultimately, if the benchmarks relying on arm's-length postings, oil sales contract prices, or spot prices fail, then value may be determined according to other relevant matters, or finally a "net-back method or any other reasonable method to determine value."

2) Arm's-Length Transactions/Exchanges

The team considered what type of transactions are at arm's-length under the regulations. Its review considered an MMS Director's decision, Cities Service Oil and Gas Corp., MMS-86-0538-O&G. The MMS Director found that in buy/sells, the price between unrelated oil companies is not necessarily the fair market value of crude oil. This decision is discussed in detail in Appendix 2.

Clearly, outright sales of oil are at arm's-length. However, the bulk of California production is disposed of under straight exchanges and buy/sell agreements. The team does not regard straight exchanges as arm's-length contracts. Additionally, the MMS Payor Handbook, Volume III, Part 3, treats straight exchanges as non-arm's-length contracts.

The team reviewed a number of buy/sell contracts[7] available from the State, and they did not appear to be outright arm's-length sales/purchases. That is, the condition of "opposing economic interest" regarding the contract wasn't apparent[8] and/or they simply didn't appear to be sales or purchases in the conventional sense. Rather, they generally appeared to be trades for mutual location/transportation benefits not unlike pure exchanges where no prices are specified.

The price reference in the buy/sell agreements the team reviewed

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[7]"Buy/sell contract" as used here means a contract where the first party agrees to deliver a fixed volume of production to the second party at a certain location, and the second party agrees to deliver the same volume to the first party at some other location. Prices are fixed in the contract for both transactions: both prices may be the same and separate charges for location differentials may be included, or the prices may differ to reflect transportation or other considerations.

[8]According to the MMS regulations at 30 CFR § 206.101, for a contract to be arm's length it must be arrived at in the market place between independent, nonaffiliated persons with opposing economic interests regarding that contract.

appears to establish a price differential between two crude oils rather than to establish the underlying price. Therefore, the team does not believe that the contracts it reviewed are true arm's-length purchase or sales agreements according to MMS' valuation rules.

B. Confidentiality Agreement

As referenced earlier, discussions between the MMS Director and State officials led to an agreement that the State would assist MMS in obtaining oil company records the State obtained through discovery during its Long Beach II litigation. The California court had placed these documents under seal because the oil companies alleged that these documents contained proprietary information. The team decided that it was critical to review these voluminous records, but due to the court's seal, California's lawyers could not immediately provide them.

With the aid of California's lawyers, the team entered into negotiations with eight major oil companies to obtain access to their documents under seal. The parties drafted a confidentiality agreement enabling the team to review the sealed records. The process started in July 1994. In October 1994, the Departments of Commerce, Energy and Interior (Departments) and the eight oil companies reached an agreement permitting the Departments to review the sealed documents these companies submitted during the Long Beach II discovery process. The Department of Justice did not enter into the confidentiality agreement, and therefore did not review the Long Beach II records during this investigation. Under the confidentiality agreement, the Departments are only permitted to share the documents with persons employed by the Departments who are working on this review. However, the confidentiality agreement does not prohibit the Departments from providing reports derived from the sealed records to employees or agents of the State or City who have access to the sealed documents.

C. Visit to Hoecker McMahon and Buck Law offices

The team arranged to examine a sample of documents from the *Long Beach II* files in December 1994. Team members met in Los Angeles at the office of attorneys (Hoecker, McMahon, and Buck) hired by the State of California in the *Long Beach* litigation. The team was shown oil sales and exchange contracts and other internal company correspondence demonstrating that California crude oil often was sold or valued for non-royalty purposes at prices higher than posted prices. Many of these documents were contracts wherein sales or purchase prices included premiums over posted prices. In the simplest of cases, the premium was explicit in the contract; in other cases it was apparent that a premium was included as transportation charges, quality adjustments, handling fees, or some mix of these and other factors.

D. Visit to State Controller's Office

The team also visited with the California State Controller's Office in Sacramento. As part of their functions, State auditors review royalty payments made under Federal onshore and 8(g)[9] leases in California. MMS provides funding for this work. The auditors briefed team members on the workings of their audit program. MMS regulations guide their oil royalty valuation reviews, and accordingly the posted price was one factor looked to by the auditors as a means of evaluating the royalty payments received. However, the State auditors were concerned about the validity of posted prices and agreed that California posted prices alone are not a valid means for assessing the value of California crude oil. In reviewing lessees' gross proceeds, State auditors found instances of premiums over postings which added to their concern about the proper method of valuing California crude oil. Accordingly, the State Controller's Office reserved the issue of undervaluation of crude oil in all of its audit documents because "California product value determination issues have not been finalized."

The State auditors continued to make efforts to capture some of the royalty undervaluation by applying the gross proceeds method to arm's-length sales by the marketing arms. Their efforts were hampered by company refusals to turn over documents about sales by their marketing arms. The State auditors expressed hope that this issue, which was being reviewed by Federal courts in the 10th Circuit and District of Delaware, would be resolved soon.

The MMS invited a representative of the California State

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[9]Refers to Section 8(g) of the Outer Continental Lands Act under which coastal states share in a percentage of royalties from certain Federal leases on the Outer Continental Shelf.

Controller's Office to attend team meetings as an observer.

E. Team Recommends Test Audits

After examining the documents from the Long Beach II files, the team recommended that MMS auditors examine records for one or more companies on a sample basis. The audit objective was to determine if sales and purchase contracts involving Federal oil contained premiums over posted prices, and if such premiums exist, to determine if Federal royalty payments reflected these additional premiums. The team recommended that these audits not stop at the first transaction between affiliates. Rather, the lessee's gross proceeds were to be tested by the first arm's-length sale by the affiliate. The team also considered time periods these audits should cover and which companies should be audited.

The team recommended audits of a sample year before and after (1) the 1985/86 oil price crash, and (2) MMS's revised oil valuation regulations took effect in 1988. The team recommended Texaco as one candidate. It always has been a large purchaser and a seller of crude in California, and its acquisition of Getty Oil in 1984 expanded its marketing activities. Thus, the team recommended an audit to cover Texaco's records in 1989 because it determined that this information could provide a good view of State-wide trading activity.

To determine how the price crash of 1986 affected the premia paid over postings for crude oil, the 1984-85 period was chosen for review. Again, Texaco would have been a good candidate except that its acquisition of Getty was in process during this period. The team then looked to Shell Oil because it was, and continues to be, the largest crude oil producer in the State and the largest royalty payor to the Federal Government. Despite a potential legal problem with obtaining Shell's documents, the team recommended that Shell be examined for 1984.[10]

In March 1995, MMS audit staff began their audit of Texaco. They decided to examine contracts for 1993, in addition to those for 1989 production, to obtain a more current picture of Texaco's royalty valuation procedures. Audit progress was slowed by Texaco's internal authorization process for accessing documents requested by the MMS auditors.

MMS initially delayed the audit process for Shell while the IBLA reconsidered its earlier decision involving Shell's disposition of production to its marketing affiliate, Shell Oil Company. MMS believed its case would be strengthened if the IBLA ruled that an affiliate's sales contracts could be reviewed by MMS when it was trying to determine if the lessee met the minimum

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[10] The problem was due to the Department's Interior Board of Land Appeals holding that an affiliate's sales contracts could not be reviewed by MMS when it was trying to determine if the lessee met the minimum requirement that royalties be based on gross proceeds. Shell Oil Co., 130 IBLA 93 (1994). The IBLA reversed its decision in May 1995 and ruled that MMS could look at affiliate records. Shell Oil Co., 132 IBLA 354 (1995) (See Appendix 1, part D. for details of this case). Shell sought review of IBLA's decision in Federal court. The case is pending in the U.S. District Court, District of Delaware.

requirement that royalties be based on gross proceeds. The IBLA reversed its decision in May 1995 and ruled that MMS could look at affiliate records.

After the IBLA reversed its decision on Shell, the audit process was delayed further because Shell claimed that its contract records from 1984, except for its Long Beach II files, had been scheduled for destruction. After several follow-up inquiries by MMS, Shell found some of these records. Auditors have examined the contracts Shell made available.

Both the Shell and Texaco audits requested to support this effort have been performed. Subsequent audits may be carried out in conjunction with collection activity.

F. Innovation & Information Consultants, Inc. (IIC) Contract

While the audit process was underway, the team suggested that it would be beneficial for MMS to retain experts the State hired for the Long Beach II litigation. IIC was heavily involved in analyzing oil sales contracts for the State/City litigation and maintained an extensive data base of contracts and other company correspondence that had been obtained in the Long Beach cases. The team felt that utilization of IIC's knowledge and experience could supplement the MMS audit effort and potentially provide backup records if the auditors were unsuccessful in obtaining them from the companies.

MMS retained IIC to provide and catalog Texaco's 1989 and Shell's

1984 California oil contracts. The agreement also requested IIC's advice to the team and MMS auditors in interpreting the contracts and investigating California crude oil undervaluation.

In addition to MMS' contractual requirements, IIC provided two reports outlining Texaco's and Shell's marketing activities in California. The reports summarize the companies' production, refinery needs, sales, purchases, and exchanges. They also address the transportation advantage/disadvantage each company faced. In short, these reports were very useful to the auditors and team in performing their work.

In the course of their work for the Long Beach II litigation, IIC developed an extensive data base of oil contract premia. This is a computer file giving estimates of the premia over posted prices contained in hundreds of California contracts. Information included contract number, trading partner names, type of crude oil, date of contract origination, volumes, and other useful information. These estimates were based on the defendants' transactions involving California crude oil where premia were involved.

The team made extensive use of IIC's contract premia data base. Some of the IIC estimates were validated by team members (see discussion below). The team employed part of this data base late in the study to estimate potential California royalty underpayment amounts that the Federal Government might be able to recover under some of the collection options outlined by the team. These options are discussed in Appendix 3.

G. Micronomics Contract

Simultaneous with the contract undertaken with IIC, MMS consulted with Micronomics Inc., which also had assisted the State in their lawsuits. The idea was to tap into other expertise in valuing crude oil in the California market and see if alternate approaches might be appropriate. MMS contracted for a report that would analyze selected California crude values for four periods from 1980 to 1993. The Micronomics study employs California spot market prices for Alaska North Slope (ANS) oil for establishing the value of indigenous California crude oil. Using this marker, the report concludes that posted prices for California crude substantially understate the market value for this oil.

In fact, companies often compared posted prices to ANS prices. In its review of company records, the team observed a number of internal corporate analyses justifying purchases of California crude oil at prices above posting by comparing the alternative of purchasing ANS crude oil -- a readily available marginal supply. After adjusting for differences in quality and refinery yields, the companies could justify paying substantial premia over posting for California crudes and still be better off than having purchased ANS crude.[11]

[11] From the mid-1970's on, Sohio (later British Petroleum) was the principal supplier of ANS to the California market. Unlike Exxon and Arco, the other main producers of ANS crude oil, Sohio had no refineries in California. This forced the company to sell as much ANS crude oil in California as possible to avoid transporting it to the Gulf and East Coasts at great expense.